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FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF THE SECRETARY

1200 EIGHTEENTH STREET, NW  
WASHINGTON, DC 20036

TEL 202.730.1300 FAX 202.730.1301  
WWW.HARRISWILTSHIRE.COM

ATTORNEYS AT LAW

October 10, 2002

EX PARTE - Via Messenger

Ms. Marlene Dortch  
Secretary  
Federal Communications Commission  
The Portals  
445 12<sup>th</sup> Street, S.W.  
Washington, DC 20554

EX PARTE OR LATE FILED

Re: CC Docket Nos. 01-338, 96-98, 98-147

Dear Ms. Dortch:

On October 9, Tom Koutsky of Z-Tel and Tim Simeone and I met with Dan Gonzalez, Commissioner Martin's Senior Legal Advisor. We distributed and discussed the attached documents at these meetings.

In accordance with FCC rules, a copy of this letter is being filed in the above-captioned dockets.

Sincerely,



Christopher J. Wright  
Counsel to Z-Tel Communications, Inc.

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**The Commission Should Continue to Require Unbundling of Local Switching  
and Other Elements Needed to Serve the Mass Market**

- I. **Z-Tel's ability to serve the mass market would be "impaired" without access to the UNE platform within any reasonable meaning of that term in section 251(d)(2)(B).**

A. **Impairment Framework:**

- Section 251(d)(2)(B) focuses the Commission's attention on whether the "failure to provide access" to a network element would **"impair the ability of the [requesting] carrier . . . to provide the services it seeks to offer."**
- Section 251(d)(2)(B) thus indicates that the impairment analysis should be a granular, service-specific inquiry into whether failure to provide the element would **reduce CLEC output.**
  - The alternative impairment framework proposed by BOCs is inconsistent with the Act because: (1) it rewrites the statute to ignore its express focus on the ability of the requesting carrier to provide the "services it seeks to offer"; and (2) it rewrites the statute to replace "impair" with "essential." Congress chose "impair," which clearly requires a far more limited showing of reduced output than would "essential."
- Focusing on intermodal competition, as urged by the BOCs, would be flatly inconsistent with the Act's emphasis on whether the **requesting carrier** would be impaired. Congress did not require new entrants to buy a cable operator as a condition of entry.
- **But whether Z-Tel would be "impaired" without access to the UNE platform does not turn on what impairment framework is adopted.** As set forth below, under any reasonable meaning of the term "impair," the record here mandates a finding of impairment absent access to the UNE platform.

B. **Z-Tel Has Demonstrated Impairment:**

- *The Mass Market is Unique:* The **mass market** to which Z-Tel seeks to offer services has distinctive characteristics that currently make it nearly impossible to serve that market without unbundled switching and the other elements of the UNE platform. These characteristics include: high churn; low incremental revenue per account; need for headache-free installation and prompt customer service; and unwillingness to enter annual contracts.
- *Hot Cut Costs are Prohibitive in the Mass Market:* The primary costs of self-provisioning switching are not for the switch itself, but for start-up, collocation, maintenance and, most importantly, hot cut costs. Z-Tel's analysis of the New

York market indicated that **even if the switch itself, collocation, and maintenance were free**, it would not be profitable to deploy a switch to serve mass-market customers in New York at a “true” hot cut cost of over \$185 found by the New York Commission.

- *Hot Cut Capacity is Insufficient to Serve the Mass Market:* The ILECs could not possibly perform the millions of hot cuts per month that would be needed in a competitive market. For example, the New York Commission recently found that if Verizon’s current UNE-P orders were converted to UNE-L orders, **Verizon’s hot cut capacity would have to expand by 4400 percent**, which is clearly not going to happen. New York Commission Comments at 4. (In fact, there are statements from the CWA in New York that Verizon is instead cutting back its hot cut capacity.) At current conversion rates and capacity, the New York Commission said that “it would take Verizon **over 11 years** to switch all existing UNE-P customers to UNE-L.” *Id.* And that would not account for adding new customers, or churn. Rather than seriously addressing the capacity issue in its Reply, Verizon baldly asserts that it is not a problem.
- *Hot Cut Reliability Remains Problematic in the Mass Market:* The BOCs tout problem-free hot cut performance 90+ percent of the time – but it is extremely difficult to build a mass-market customer base when there *any* significant chance of losing phone service. These errors occur in bulk, or “project” hot cuts as well – because they still ultimately rely upon manual provisioning. **Unlike business customers, mass market customers cannot save enough to justify the possibility of losing service.**

C. **The BOCs’ “UNE-Fact Report” Supports Z-Tel’s Arguments:**

- *The BOCs’ Report Suggests that Competitive Carriers Currently Serve, at Most, About 1/10 of 1% of the Mass Market via UNE-L:* “Figure 4” of the “Fact” Report shows that – putting aside cable franchises – the BOCs were able to find only nine companies that purportedly serve 25,000 or more residential lines. But the vast majority of those lines are **not served via UNE-L**. The “Figure 4” companies are primarily either ILECs or cable overbuilders – and no one seriously thinks that the Act is only about enabling competition by such companies. And even among those companies, **most either never sought to serve the mass market, or have abandoned plans to do so.**
- *The BOCs’ Latest List of CLEC-Deployed Switches:* The BOCs’ list of CLEC switches is entirely dominated by companies that obviously do not use their switches to provide services to the mass market via UNE-L. **Instead, they primarily serve medium-sized and large business customers, for whom it makes economic sense to aggregate loops at the customer’s premises and provide service at a DS1 interface or higher. This avoids the need for manual analog hot cuts at the ILECs’ central office to serve these customers.** (Large businesses with intensive bandwidth needs are a different market than the mass market – they will

agree to sign long-term contracts and can tolerate some degree of manual installation.) Z-Tel (like other commenters) estimates that aggregation may become economically viable at about 16-20 lines.

***D. Z-Tel's Impairment Arguments are Fully Consistent With USTA v. FCC:***

- *Z-Tel has Urged that Impairment Analysis Should be Market-Specific:* USTA faulted the Commission for adopting impairment rules of “unvarying scope.” Z-Tel wholeheartedly agrees with the D.C. Circuit’s view that the large business and mass markets should be distinguished and analyzed separately.
- *Cost Disparities:* USTA cautioned that impairment cannot properly be based on “cost disparities” that would be “faced by virtually any new entrant in any sector of the economy.” But the **hot cut (and related) costs giving rise to impairment for CLECs seeking to serve the mass market are unique to that market** – Z-Tel is not aware of *any* other industry where new entrants must pay established monopolists for the privilege of attracting the monopolists’ customers.
- *Verizon:* The Commission must be cautious not to over-read USTA. Verizon expressly indicated that the Act is intended to promote broad unbundling to give “aspiring competitors every possible incentive to enter local” markets and overcome the monopolists historical advantage. Accordingly, *dicta* in USTA to the effect that the Commission should limit unbundling to facilities with natural monopoly characteristics must be viewed with skepticism, particularly since the Commission’s next order will not necessarily be reviewed in the D.C. Circuit.

***II. The Commission should continue to recognize state authority to establish additional unbundling requirements.***

- *Plain Language:* Section 251(d)(3) expressly provides that the FCC “shall not preclude the enforcement of any regulation, order, or policy of a state commission that . . . establishes access and interconnection obligations of local exchange carriers.” When the Commission tried, in 1996, to construe this language to prohibit state unbundling rules that were inconsistent with the Commission’s regulations, the Eighth Circuit reversed. The court held that section 251(d)(3) was meant “to shield state access and interconnection orders from FCC preemption.” *Iowa Utilities Board*, 120 F.3d at 807.
- *States are Better Able to Undertake the Required Granular Analysis:* As NARUC’s comments noted, “[s]tate regulators have access to the detailed real-world information that is essential” to determining what UNEs should be unbundled in particular markets. NARUC Comments at 7. State regulators are able to employ **fact-finding procedures**, including detailed discovery, live testimony, and cross-examination, that are not generally available to the FCC. *Id*

- *State commissions support the UNE platform for mass market consumers:* Those states that have undertaken detailed analysis of the need for UNE-P have generally endorsed state-wide unbundling of the UNE platform for the mass market. New York and Texas, in particular, correctly emphasized hot cut bottleneck problem in reaching that conclusion.

### III. **The section 271 checklist requires the BOCs to unbundle loops, transport, and switching, and there is no basis for forbearance from its requirements at this time.**

#### A **Section 271**

- *Plain Language:* The second item on the checklist requires BOCs to provide “[n]ondiscriminatory access to network elements” in accordance with sections 251(c)(3) and 252(d)(1). Items four through six of section 271 require that “loop transmission,” “transport,” and “switching” be provided on an “unbundled” basis. The two provisions thus plainly require that the BOCs provide unbundled access to loops, transport, and switching at cost-based rates and in accordance with the other provisions governing interconnection agreements.
  - There is absolutely **no textual support** for Verizon’s contention that loops, transport, and switching suddenly cease to be “network elements” if the Commission finds that they need not be unbundled under section 251(d)(2).
- *The Problem of “Surplusage”:* Construing the checklist as the BOCs advocate to require only what section 251(d)(2) requires would violate a “cardinal principle” of statutory construction -- it **would render the checklist items mere “surplusage.”** The checklist items have meaning only if BOCs are required to unbundle those elements even *after* those items are not required to be unbundled pursuant to the standards of section 251.
- *The Commission’s Prior Construction of Section 271:* In the *UNE Remand Order*, the Commission expressly construed section 271(c)(2)(B) to “require[] BOCs to . . . provid[e] . . . to requesting carriers the following network elements: local loops, transport, switching, databases and signaling.” 15 FCC at 3905. Agreeing with the BOCs now that section 271 does not require unbundling independent of that mandated by section 251 would oblige the Commission to repudiate its earlier interpretation of section 271.
- *Maintaining Unbundled Switching and the Other Elements of the UNE-P Necessary to Serve the Mass Market Would Serve the Core Purposes of the Act*
  - *Congress Intended the Act Is to Eliminate the Local Monopoly:* According to the Supreme Court, the Act was intended to introduce competition to “persistently monopolistic local markets, which were

thought to be the root of natural monopoly in the telecommunications industry.” *Verizon*, 122 S. Ct. at 1654. The act was “designed to give aspiring competitors every possible incentive to enter local retail telephone markets, short of confiscating the incumbents’ property.” *Id.* at 1661.

- There is absolutely no statutory basis for Verizon’s view that Congress intended competition using leased network elements to be just a short-term, transitional measure. Both the *AT&T* and *Verizon* cases indicate that Congress intended UNE-based competition to be one of three equally important modes of competitive entry.
- *Congress Intended Parity Between Local and Long Distance Entry*: Congress expressly envisioned that “[w]hen we open local service exchanges to competition, then the Bell operating systems will [be able to] go out and compete in the long distance market.” 141 Cong. Rec. S8,135 (Sen. Dorgan). As Senator Breaux put it, “You can get in my business when I can get in your business.” 141 Cong. Rec. S8,153. BOCs can now “get in” the long distance business (once they receive section 271 authorization) by simply leasing interexchange capacity and paying less than \$5 per customer to switch the customer electronically to its service. In contrast, for a CLEC like Z-Tel to “get in” the local market via UNE-L (as the BOCs would require), the CLEC must pay tens or even hundreds of dollars per customer in hot cut costs. Because that is simply not a viable entry strategy, under the BOCs’ approach, no “parity” would exist.
- *Congress Intended that the BOCs Must Provide Loops, Transport, and Switching for the “Reasonably Foreseeable Future”*: Congress knew that local competition would not develop overnight. Senator Pressler, the sponsor of the Senate Bill, explained that the checklist would require the BOCs to continue to unbundle the three core elements for the “reasonably foreseeable future.” 141 Cong. Rec. S8,469 (Sen. Pressler).

***B. No Justification for Forbearance***

- *Verizon’s Petition is Premature*: So long as the BOCs are required to unbundle loops, transport, and switching under section 251(d)(2), the question of “forbearance” from 271 does not arise. The Commission should require Verizon to refile after issuance of a Triennial Review decision, to **avoid wasting everyone’s time now**.
- *Verizon’s Forbearance Argument Just Repeats its Erroneous Statutory Interpretation*: Verizon’s “forbearance” argument essentially ignores the requirements of section 10. Verizon’s entire “forbearance” argument rests on its

assertion that the section 271 checklist adds nothing to the requirements of section 251(d)(2). That argument would render the checklist mere “surplusage.”

- *The Anti-Backsliding Provision:* Section 271(d)(6) provides for a range of penalties “if the Commission determines that a Bell operating company has ceased to meet any of the conditions required for [section 271] approval.” Accordingly, it is clear that section 271 is not “fully implemented” simply because the checklist has been initially satisfied. Section 271 imposes continuing obligations.
- *Constitutional Issues:* “Forbearing” from enforcing section 271 would raise serious questions about the Commission’s section 10 authority. The forbearance provision represents an unprecedented delegation from Congress to the Commission of authority to repeal portions of the Act. The Supreme Court has held that the President may not constitutionally be authorized to repeal portions of an Act, *see Clinton v. City of New York*, 524 U.S. at 439, and neither may the Commission.
- *Unbundling Should be Maintained Until There are Alternative Sources of Supply:* Contrary to the BOCs arguments, Z-Tel does not urge that the UNE platform should be preserved in perpetuity. The key question, though, is: “What must occur before a CLEC like Z-Tel **could viably serve the mass market**, in the absence of the platform?” The answer is clear: Z-Tel would need to be able to get the elements of the platform from someone other than the current monopolists – *i.e.*, **from a fully-functional wholesale market** that can provide seamless conversions at sufficient capacity to meet demand. That is the situation today for the BOCs in the long-distance market, where they lease wholesale capacity.

## **Empirical Papers on UNE Competition**

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**What Determines Wholesale Prices for Network Elements in Telephony? An Econometric Evaluation**, George Ford and Randy Beard (Auburn University), PHOENIX CENTER POLICY PAPER NO. 16 (September 2002).

The BOCs' claim that state commissions have failed to base element rates on forward-looking cost (as required by the FCC's TELRIC standard) is evaluated econometrically. In contrast to the BOCs' assertions, forward-looking economic cost is the primary determinant of wholesale prices for network elements. Retail prices play no direct role in determining wholesale prices for UNEs. However, the state commissions have, according to the statistical model, set wholesale prices above forward-looking costs to provide the BOCs about half of their existing retail margins. While so, forward-looking costs are, by far, the more important determinant of wholesale prices for UNEs. Mr. Seidenberg was wrong – the state commissions 'do get it.'

**Unbundling and Facilities-Based Entry by CLECs: Two Empirical Tests**, by George S. Ford, Ph.D. and Michael D. Pelcovits, Ph.D. (former MCI Chief Economist, now with the consulting firm MICRA).

The number of lines served on CLEC-only facilities (i.e., pure facilities based) is positively related to market size and market density, and negatively related to the price of unbundled loops and unbundled switching. In an alternative test, the authors find that RCN's entry is negatively related to the price of unbundled loops. Thus, there is no evidence that there is more facilities-based entry where UNE rates are higher. In fact, the opposite is true.

**Make-or-Buy? Unbundled Elements as Substitutes for Competitive Facilities in the Local Exchange Network**, Randy Beard (Auburn University) and George Ford, PHOENIX CENTER POLICY PAPER NO. 14 (September 2002).

The amount of CLEC entry using unbundled elements is highly sensitive to the price for such elements. A 10% increase in the price of an unbundled loop or switching reduces CLEC lines by more than 10% (i.e., the demand for UNEs is *elastic*). The cross-price elasticity between loops purchased with and without switching is zero. Thus, UNE-Platform does not reduce the demand for UNE-Loop (as the BOCs claim). From an antitrust perspective, the findings in this paper indicate that UNE-Loop and UNE-Platform service different markets. The paper also includes a statistical test of impairment with respect to switching, and finds that impairment exists.

**Facilities-Based Entry in Local Telecommunications: An Empirical Investigation**, Randy Beard, George Ford, and Tom Koutsky.

This paper shows, using econometrics, that the deployment of end-office switching by CLECs is not attenuated in markets where unbundled switching prices are low. Instead, CLEC deployment of switches is actually higher in markets with low switching rates. A theoretical model explains the possible relationships between deployment and unbundling, and the theory provides no unambiguous conclusions (low switching rates may increase or decrease CLEC switch deployment). Thus, the issue is plainly empirical. The empirics show that low switching rates increase deployment.



**Preliminary Evidence on the Demand for Unbundled Elements**, Robert Ekelund, Jr. and George Ford (forthcoming in *Atlantic Economic Journal*, December 2002).

This paper estimates the demand elasticity for UNE-Platform. The paper finds that a 10% increase in the price of UNE-P elements reduces quantity of UNE-P sold by 27%. Thus, it is little surprise that the BOCs are now attacking the price of UNE-P elements, as well as availability.

**Why ADCO? Why Now? An Economic Exploration of Industry Structure for the "Last Mile" in Local Telecommunications Markets**, Randy Beard, George Ford, and Larry Spiwak (published in the *Federal Communications Bar Journal*, 2002).

This paper explains why the "transition to facilities" argument is meritless. The supply-side economics of local telecommunications prohibits a large number of facilities-based competitors. This is not true on the retail side. Much like the current long-distance markets, where about 900 retailers are serviced over about 5 nationwide fiber networks, industry structure in the local market must bifurcate into a retail and wholesale segment for real competition to exist. Unbundling allows CLECs to acquire market share, which then serves as a non-ILEC demand for local exchange network. Without unbundling, there is not demand for alternative networks – consumers don't demand network, carriers do. Without available and effective demand, the costs of constructing local network can never be recovered – as is evident in the collapse of the segment of CLEC industry which adopted a "built it and they will come" business plan. The prudent path, made possible by unbundling, to "build it after they come."

**A Fox in the Hen House: An Evaluation of Bell Company Proposals to Eliminate their Monopoly Position in Local Telecommunications Markets**, PHOENIX CENTER POLICY PAPER NO. 15 (September 2002).

Between UNE-P, UNE-L, and full facilities-based entry, the BOCs' revenues are greatest with UNE-P. The other forms of entry leave BOC network stranded. Why then, do the BOCs prefer facilities-based competition? The answer is obvious. While the BOCs may lose more profit on a per-line basis from facilities-based entry, there is considerably less of it. By slowing competitive growth to a trickle, the total loss in margin is trivial. UNE-P, alternately, allows for the rapid growth of competition, and while BOC margin loss is less, the total margin loss is greater.

## WHERE UNE-P IMPLEMENTED, CONSUMERS BENEFIT STATEWIDE

*With manually-provisioned UNE Loops, competition is scant and concentrated*

The ability to provision orders electronically and ubiquitously allows competitors to utilize UNE-P to offer mass market residential and small business consumers a competitive choice today. The data below, obtained from SBC and BellSouth through discovery in state proceedings and aggregated here, clearly shows that UNE-P provides **geographically ubiquitous** competitive mass-market coverage. Other forms of entry – notably UNE Loop – are not ubiquitous. Because of this potential ubiquitous competitive response, it is no surprise, then, that State regulators have implemented UNE-P under state law as part of retail price cap regulation of ILECs.

### Where's the Competition in Texas?

#### Local Entry By Size of SBC Central Office (Oct 2001)

Wire Center Ranking	Average Lines/CO	Competitive Penetration	
		UNE-L	UNE-P
The 10% Largest Wire Centers	102,571	2%	8%
Next 10%	54,443	1%	11%
Next 10%	34,139	1%	12%
Next 10%	20,331	0%	13%
Next 10%	12,309	0%	16%
Next 10%	7,218	0%	17%
Next 10%	4,265	0%	18%
Next 10%	2,532	0%	21%
Next 10%	1,373	0%	25%
Smallest 10% Wire Centers	485	0%	21%

### Where's the Competition in Georgia?

#### Local Entry By Size of BellSouth Central Office (2002)

Wire Center Ranking	Average Lines/CO	Competitive Penetration	
		UNE-L	UNE-P
The 25 Largest Wire Centers	67,977	3%	6%
Next 25 Largest Wire Centers	40,012	2%	9%
Next 25 Largest Wire Centers	26,616	1%	8%
Next 25 Largest Wire Centers	13,542	0%	8%
Next 25 Largest Wire Centers	6,943	0%	6%
Next 25 Largest Wire Centers	3,875	0%	7%
Smallest 28 Wire Centers	1,697	0%	6%



# Unbundled Local Switching and UNE-P

Thomas M. Koutsky  
Christopher J. Wright  
Timothy J. Simeone  
October 9, 2002

CC Docket No. 01-338, 96-98, 98-147



## **Z-Tel's Innovative Uses of UNE-P**





# Z-Tel: Quick Facts

- ▶ Leading UNE-P-based services provider headquartered in Tampa, Florida
- ▶ 925 Employees with \$41K annual average salary
- ▶ **200,000 current residential and small business retail lines in service in 46 states**
- ▶ **We own facilities and develop services – and we utilize UNE-P to connect mass-market customers in 46 states to them**
- ▶ Key wholesale partner behind The Neighborhood™ built by MCI
- ▶ Founded in 1998 & public since December 1999
- ▶ \$250MM annual revenue
- ▶ EBITDA positive w/ minimal debt
- ▶ **Innovation:** unique Internet-accessible calling and messaging features
- ▶ **The Future:** voice recognition dialing, personal and organizational directories





# First Nationwide Local Phone Company



Mass-market consumers in red can get Z-Tel service today



# Z-Tel: What UNE-P is Supposed to Be

**Innovative and new local services to  
*mass-market residential and small  
business customers nationwide***

For example,

Remote access to calling & messaging via phone or Web  
Internet-accessible voicemail  
Multiple-number Call Forwarding  
Dial-by-voice functionality  
Web conferencing



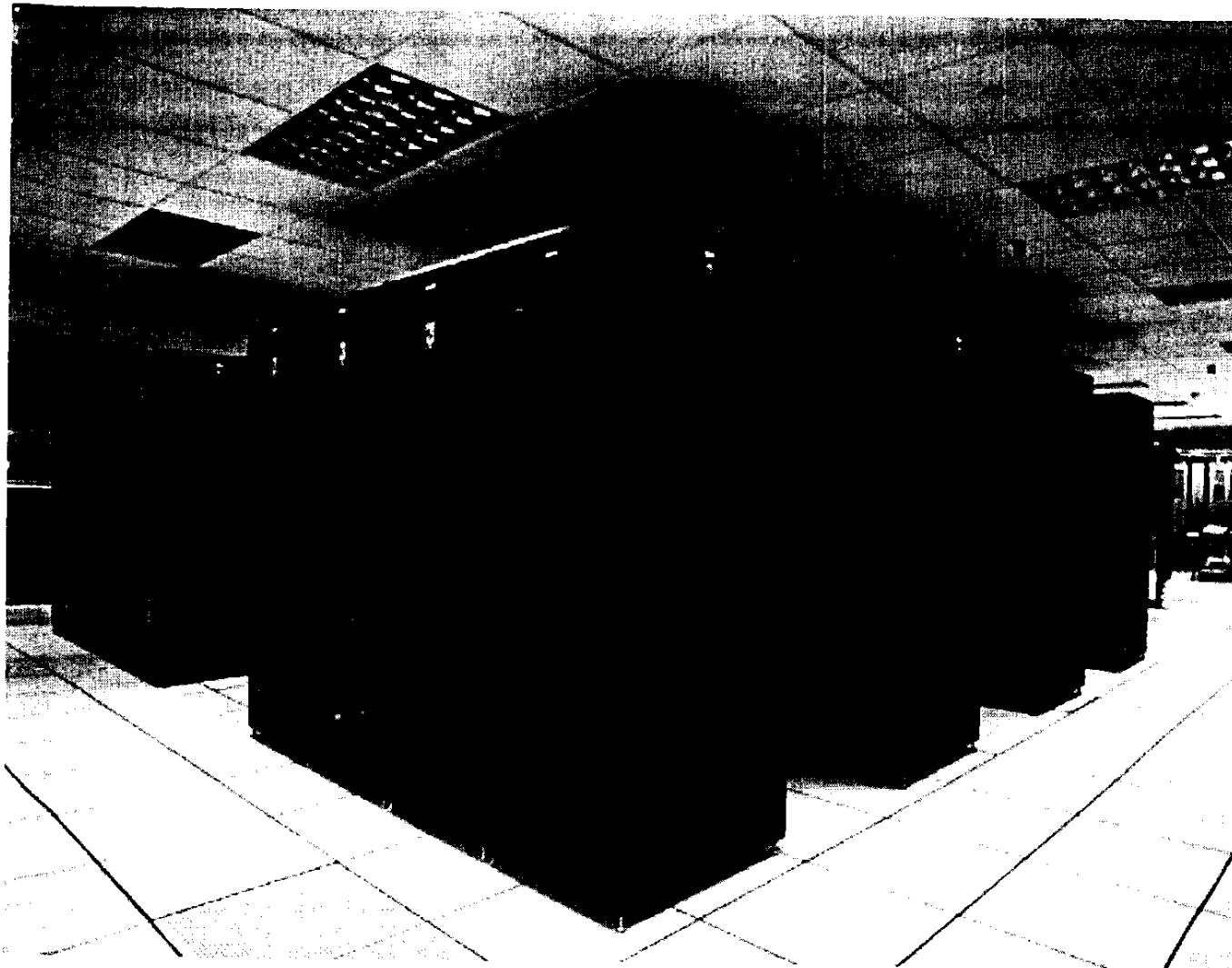
# Innovative Mass Market Services: The Present and Future of UNE-P

- Z-Tel has invested \$150MM in developing new applications for the telephone
- People like these services and the simplicity
- Z-Tel Network Architecture utilizes local switches as “dumb” pass-through instruments
- Access to local switching necessary to reach low rev/mth mass market customer – it is only mechanized and efficient method of providing local service





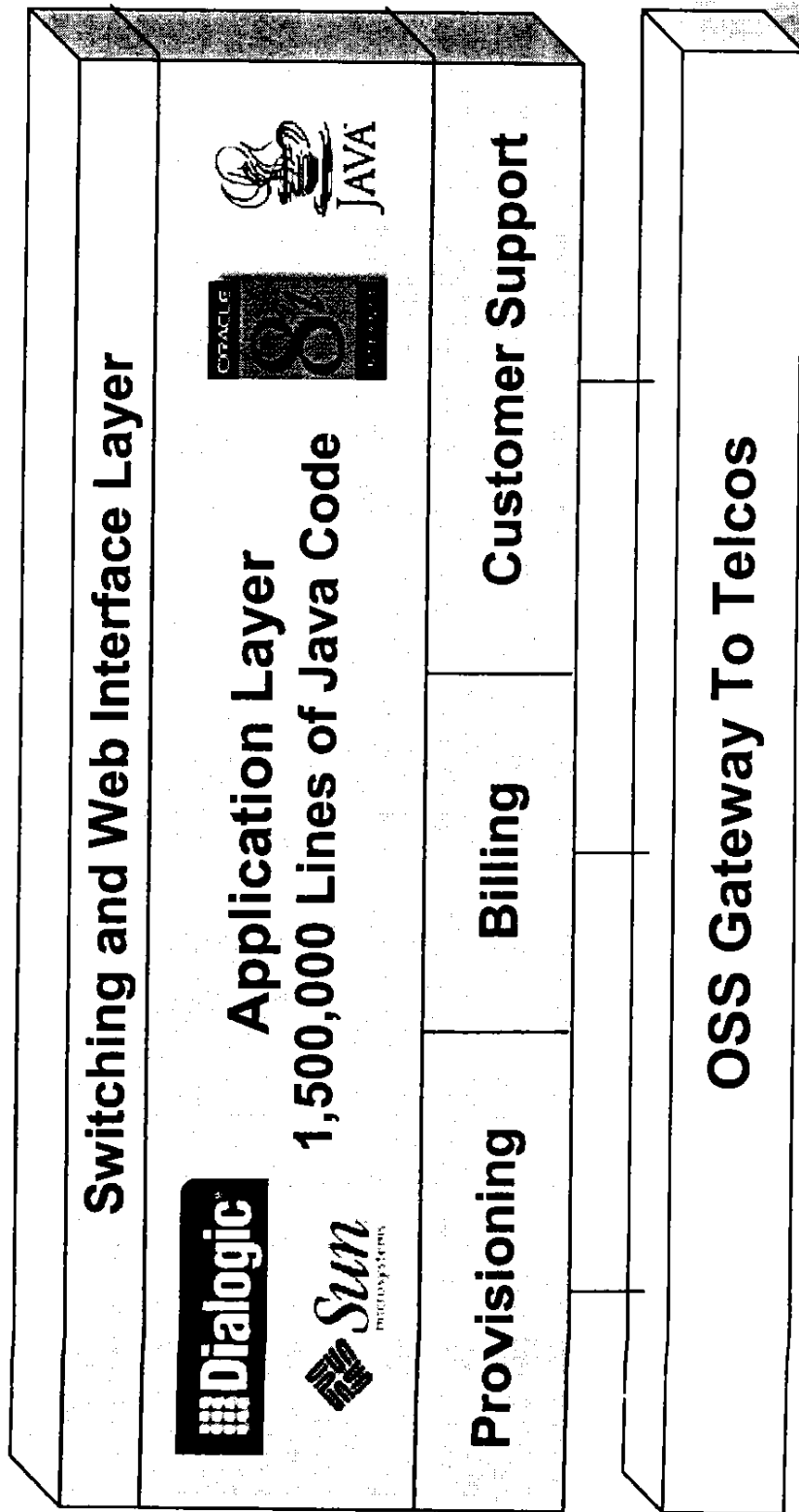
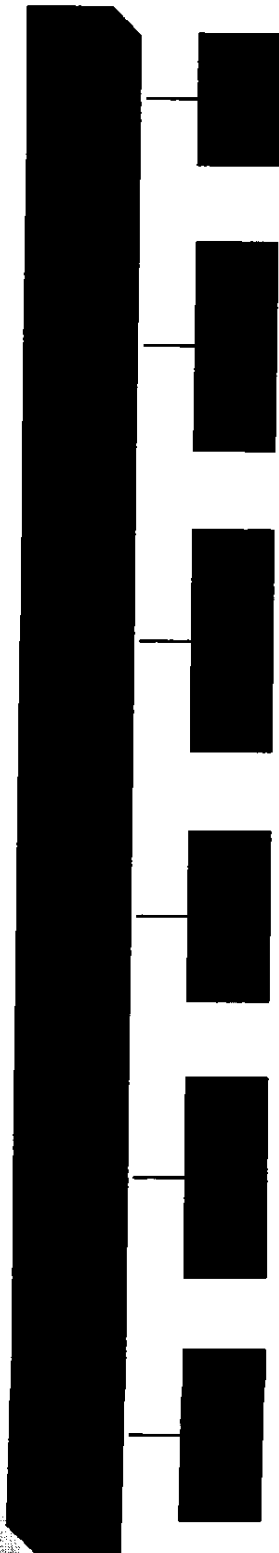
**2 million customer  
interactions per day**



**Z-Tel Data Center – Tampa, Florida**

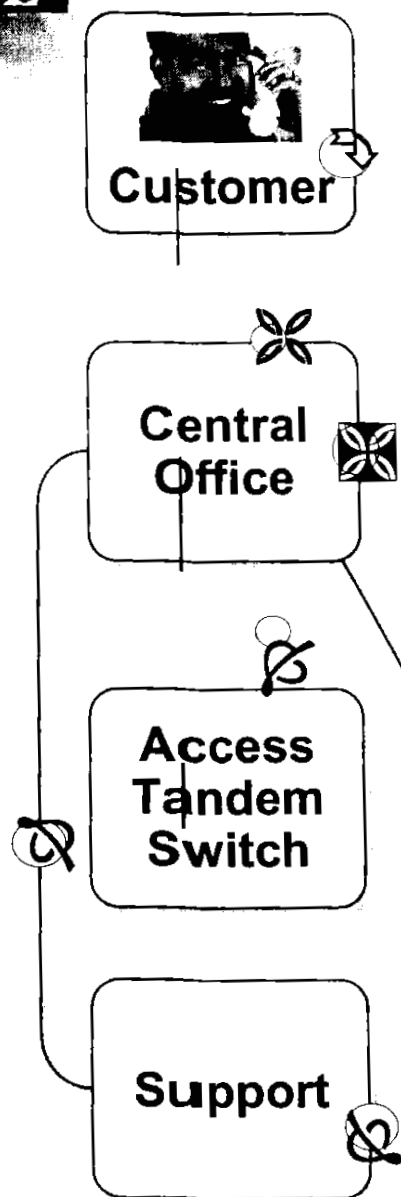


# Z-Technology: \$150 Million Invested





# UNE-P Fosters Service Innovation



## Elements:

- Network Interface Device
- ✕ Local Loop
- ✕ Local Switching
- ✕ Interoffice Transport
- ✕ Signaling and Call Related Databases (AIN)

*All specifically written by Congress into Section 271 long-distance "competitive checklist"*

*We do all of the work to support the customer: service, billing, configuration, support, and collections*

**With unbundled access to the switch port, we can add our own technology to the service and access customer in reliable, mechanized manner**



# We're Going To Keep Raising the Bar

*Today, Z-Tel uses UNE-P to offer...*

New and innovative technology

Unlimited calling—no more long distance or local calling charges

Immediate cost savings of 15 to 25% off combined bills

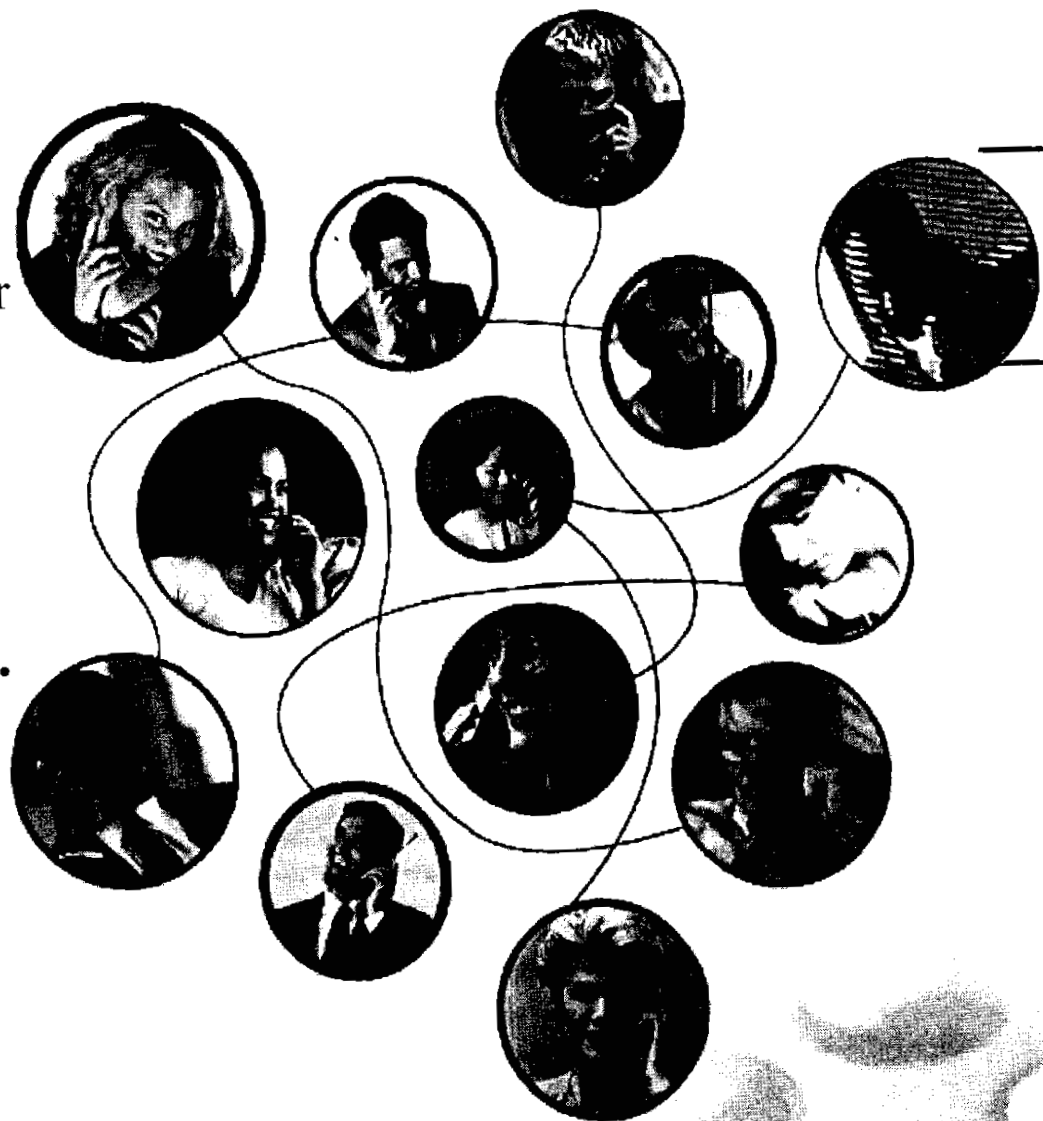
—Web-based call management

*Tomorrow, Z-Tel will use UNE-P for...*

Voice recognition dialing

—Personal Voice Assistant

Family and community conferencing,  
directory and message services





# UNE-P and Competition: Today and Tomorrow



## UNE-P Today

- Consumers only now beginning to see choice –  
*8-10MM UNE-P lines today, principally residential and small business*
- New and innovative service providers like Z-Tel account for 43% of all UNE-P lines
- UNE-P Entry occurs *statewide* and in *rural* areas
- Only UNE-P method can support quantities of entry needed to serve mass market
- Increases non-incumbent demand for network infrastructure
  - Consumers don't demand network facilities – service providers do!
  - Independent UNE-P carriers serving mass market demand *and will migrate* to independent, non-ILEC sources when those non-ILEC sources can provide seamless access in sufficient quantities
- FCC should **foster non-ILEC sources of demand** for facilities (like Z-Tel) – not put us out of business



# UNE-P to Facilities-Based?

*On per-line basis solely in theory, self-provided switching may be cheaper than ULS, but we still buy it because...*

- Only way to meet mass market demand and volumes
- Low rev/line + churn + quality demand = mechanized provisioning
- Cannot “fill up” own switch with manual hot cut process
- Self-provided switching is a forced “gating” of our business – which is selling software
- Diversion of scarce capital into replicating local switches
- And in the end – UNE-Loop entrant *just* as dependent upon ILEC!  
(Indeed, probably more so...)

**Empirical research supports Key  
Role UNE-P Plays in Mass Market**



# Empirical Research on UNE-P

## ***Res/Small Business Competition greater where unrestricted UNE-P***

- Z-Tel Policy Paper No. 3
- Data: FCC Local Competition Reports

## ***Positive linkage between UNE-P and facilities investment***

- Z-Tel Policy Paper No. 4
- Beard, Ford and Koutsky, *Facilities-Based Entry into Local Telecommunications* (2002)
- Pelkovits and Ford, *Unbundling and Facilities-Based Entry by CLECs* (2002)
- Data: looks at switch deployment over time, using FCC Local Competition data, LERG

## ***UNE-P and UNE-L are not substitute entry strategies***

- Beard and Ford, *Make or Buy? Unbundled Elements as Substitutes for Competitive Facilities* (2002)
- Forced “transition” result in market exit, not “substitute” one form of entry for another

## ***Bells make money selling UNE-P to Z-Tel***

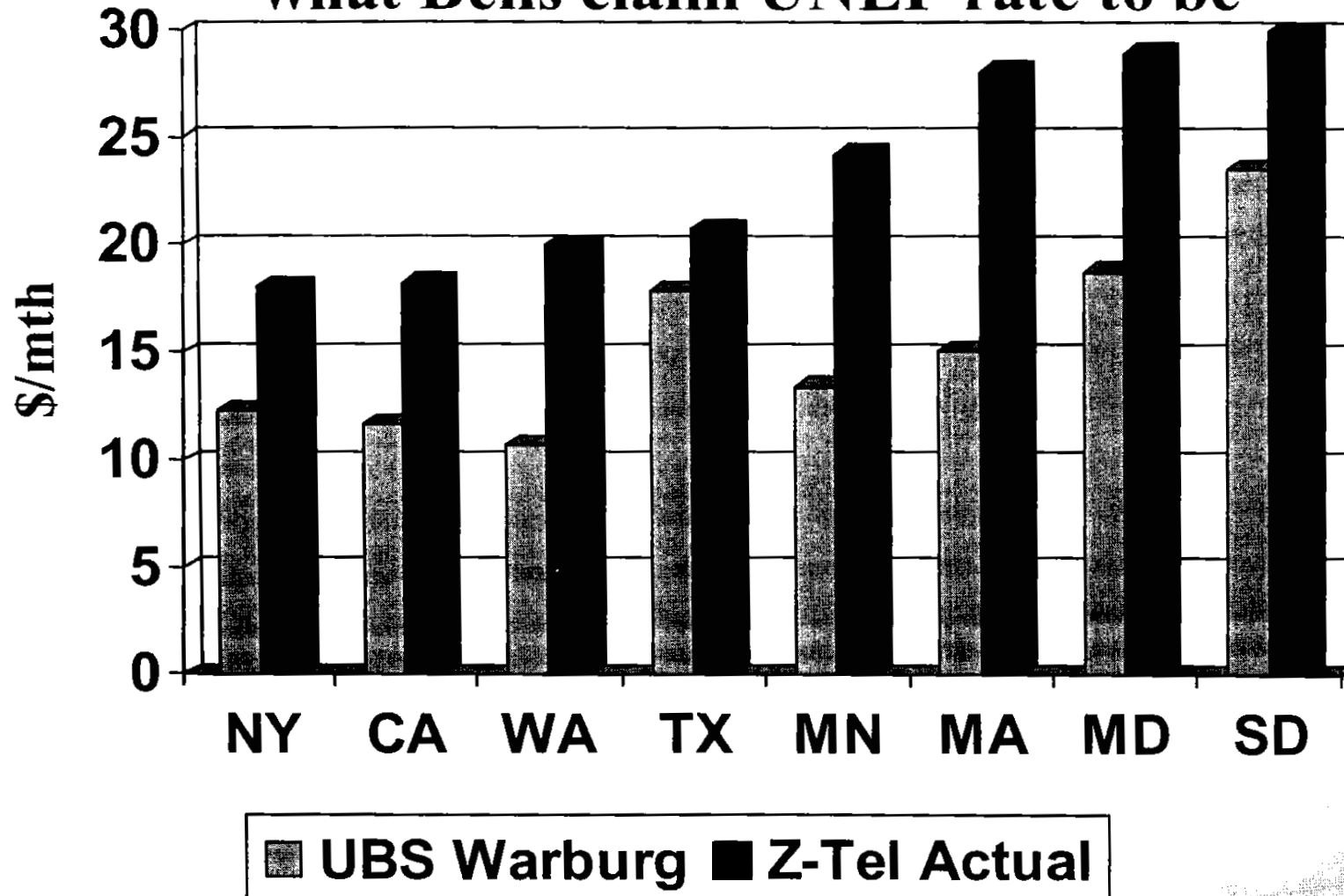
- September 23 and 30, 2002 Z-Tel ex parte letters to Chairman Powell
- SBC CFO confirms that competition in Texas – ***where UNE-P has been and is now available without restriction*** – is “workable” and “doable”
- Wall Street reports substantially misstate actual costs of UNE-P





# UNE Rates: Bell Myth; Z-Tel Reality

Z-Tel actual payments >25% more than what Bells claim UNEP rate to be





# Bells Crying Wolf?

- BOCs average over 50% EBITDA margin selling UNEP to Z-Tel
- Margins **more** than sufficient to cover depreciation and “investment”
  - Z-Tel UNEP payments compared to actual Bell ARMIS operating costs
  - Z-Tel Sept. 23, 2002 letter to Chairman Powell and NARUC President Nugent
  - Z-Tel Sept. 30, 2002 letter to Chairman Powell and NARUC President Nugent
  - Phoenix Center Policy Paper No. 16
- Bells dramatically overstate impact of UNEP; understate UNE-P revenue by over 25% -- or \$7/month per line.
- Bell argument proves that UNE-P and other forms of entry not substitutes – because if all UNE-P lines immediately moved to CLEC facilities, *the Bells would lose another \$3B per year!*

**Debate *not* about “what type of competition to have” but about returning lost customers to Bells and increasing prices**



# UNE-P: The Future

- In considering, “What happens after UNE-P?”, FCC should not adopt paradigm that “locks in” particular model of competitive entry
- UNE-Loop entrants are *just* as dependent upon ILEC as UNE-P entrants
  - They cannot serve customers without loops and collocation
  - UNE-Loop entrants will have invested millions of dollars into a network architecture that mirrors the Bells – same COs, same loops
  - Potential for UNE-Loop “lock in” – once millions invested in ILEC network architecture, will that entrant *ever* migrate away from ILEC any further?
- UNE-P entrants free to migrate customers *totally* away from ILEC network once those networks are built
  - Since no CapEx associated with ILEC architecture, **UNE-P customer base is mobile**
  - If FCC wants new networks, facilitating open bidding for mass-market customer bases helps – locking CLEC customer bases into perpetual ILEC loop dependence does not
  - **These alternative networks will not be built without “customers first” – UNE-P provides that customer base**
  - *See* Beard, Ford and Spiwak, “Why AdCo?”, 54 Fed Comms. L. J. 421 (2002).



# Legal Hurdles in Restricting ULS/UNE-P





# Legal Hurdles

- Core elements of UNE-P (loops, switching and transport) specifically listed in section 271 checklist
  - Legislative history: checklist contains “at a minimum” what should be unbundled under section 251
  - Consistent with purpose of the Act to provide “parity” of “equal access” between IXC’s and ILEC’s into one another’s markets
- Restricting any section 271 element would require section 10 forbearance (Verizon petition) – which is sharply limited
- Application of forbearance by FCC as requested by Verizon exceeds constitutional bounds of FCC’s authority
- Additional state unbundling or access requirements specifically preserved in section 251(d)(3).
  - States adopted core elements of UNE-P under state law before and after Act passed.
  - There is no legal “inconsistency” between an FCC decision not to order unbundling nationally and a state order ordering unbundling locally



# Utilizing State commissions can help

*USTA Issue: fact-based, granular analysis that does not provide unbundling of “unvarying scope”*

- Rather than illegally preempt states, enlist their assistance
- States can **help** FCC write rules that pass legal muster
- Example: States do fact-finding with regard to whether impairments continue to exist – with particular focus upon whether reduction in output would occur in their states
  - Discovery
  - Cross-examination
  - States that have done this to date have found the UNEP access is warranted to serve the mass market (see Texas) – **current evidence in Triennial Review docket is insufficient to rebut those findings**
- Example: States examine impact of unbundling and UNE-P on retail price regimes (as in NY and IL today)
- FCC can utilize these state findings to determine future federal unbundling rules or applications of those rules



# Impairment Analysis Framework



# Proposed Impairment Framework

1. Begin with market definition – the “service” requesting carrier “seeks to provide”
  - E.g.: the local telecommunications mass-market (Z-Tel Comments Attachment A, or >139MM lines)
  - Consistent with FCC precedent in prior Orders
  - Provides “granularity” *USTA* requests
2. What are the demand-side requirements of “serving” that “market”?
3. What are supply-side requirements of “serving” that “market”?
4. Without unbundled access, can entrant serve as many customers within 2 years as with unbundled access?





## Ford Reply Decl. Section III

*Impairment exists when a lack of access to an ILEC network element reduces a CLEC's output by a small, but significant, and non-transitory amount*

- Complies with *USTA* -- a fact-based analysis
- Requires FCC to consider whether alternatives to element...
  - Are available from other sources in sufficient quantity and quality
  - Can be utilized by entrant in seamless manner
  - Can be implemented without adversely affecting customer service *at service level demanded by consumers for that service*
  - Can be implemented without adversely affecting competitive output
- Flexible enough to consider prices, the “profitability” of particular entry strategies, the “difficulty” of self-provisioning
- “Significant and non-transitory” are objective “limiting principles” grounded in antitrust law
- Allows for state input and assures no significant customer dislocation



**But under any reasonable impairment standard, Z-Tel is impaired to serve the Mass Market without ULS/UNE-P**



# The “Analog Mass Market”

1. In BOC Merger Orders, FCC has identified “mass market” for local services that includes residential and small businesses
2. Demand-Side Characteristics of the Mass Market
  - Low revenue per month (\$40-80/line)
  - Highly reliable service (turn up service quickly, repairs <24 hrs, etc.)
  - Regulatory requirements (lifeline, installation/disconnection service requirements)
  - Diffuse consumer base
  - No long-term contracts/month-to-month service
  - High churn (5%-10%/mth)
3. To profitably serve Mass Market, carriers must...
  - Keep costs of customer acquisition low
  - Have reliable, electronic method of service provision
  - Be able to service churn profitably
  - Sell through mass market advertising techniques (ubiquitous coverage with consistent product)



# Essentially No UNE-L Competition in Mass Market

- The BOCs' own "UNE-Fact Report" suggests that CLECs -- *i.e.*, putting aside cable franchises and small ILECs -- currently serve at most 1/10 of 1% of the mass market via UNE-L.
- Of the nine "CLECs" in "Figure 4" of the BOCs's Report that supposedly serve 25,000 or more residential lines, most are either cable overbuilders or ILECs.
- The Act does not require a competitor to buy a cable company or an ILEC in order to compete.
- Moreover, nearly all of the "Figure 4" companies either never sought to serve the mass market or have abandoned plans to do so
- Without proof of actual market success, claims that CLECs simply can "transition" to UNE-Loop to serve Mass Market ring hollow



## Mechanized Provisioning: Essential to Providing Mass Market Services

- Over 139MM analog dialtone lines on Bell/GTE networks – supporting competitive entry requires large quantities
- ILECs serve this market in largely automated manner – they do not do a hot cut each time an analog dialtone customer adds a line or turns up service
- With low revenue/mth, regulatory service quality requirements, and high churn – CLECs *must* be able to have similar automated access to serve these customers profitably
- Project hot cuts do not and cannot solve this fundamental disparity – because still relies on manual provisioning for *all* CLEC lines while ILEC keeps mechanized access

**Loop-port combination of UNE-P is today the *only* access method that provides mass market entrants like Z-Tel automated, nondiscriminatory provisioning**



# The Hot Cut Bottleneck

- No wholesale market of sufficient capacity exists anywhere – let alone with sufficient capacity
- “Hot-cut” capacity limits self-provisioning/UNE-L entry
  - Example: 5% churn per month
  - If ILEC can provide only 15,000 hot cuts per month in a state...  
**maximum Mass Market Penetration for that CLEC is 300,000 lines**
  - *In NY, that would cap a CLEC's entry at 2.3% of the market*
  - Project hot cuts not adequate to serve mass market, as manual provisioning and mass market customers not sign term contracts.
  - “Transition” to UNE-L would require CLEC to enter two businesses simultaneously *and* double-pay for switching while conversion happened
- Mechanized Access through UNE-P *can* support such volumes
  - NY: 250,000 UNE-P conversions in December 1999
  - GA: BellSouth converted 1% of its lines via UNE-P in Summer 2001
  - 8-10MM UNE-P lines in service nationwide today



# Provisioning Cost Barrier

- UNE-L conversions are expensive and manual
  - Manual Provisioning Process; backward-looking multi-step process
  - Verizon and NYPSC: each hot cut costs over \$180!
  - FCC cannot assume that the hot cut rate is lower – nor can it subsidize below-cost hot cuts
- Even if manual hot cuts were available in unlimited quantities, still place material limitation on quality of CLEC product
  - CLEC pay for manual provisioning of every line = cannot compete with Bells who have mechanized access
  - Manual error: to support mass market entry, huge volumes would be required
  - Even an optimistic success rate would still mean putting out of service hundreds of thousands of existing UNE-P customer lines (450,000 if 95% “success”)
- Transport costs and inefficiencies add to UNE-L costs



## Network Impediments to Mass Market Entry

- Z-Tel retail customer densities not sufficient to warrant collocation or transport investment
  - Z-Tel has UNE-P lines in 4207 ILEC central offices
  - In 87% of those COs, Z-Tel has less than 50 lines
  - In 94% of those COs, Z-Tel has less than 100 lines
- Collocation is expensive; ILECs fight efficient arrangements
- ILECs possess switch/transport network density economies because they were bequeathed monopoly by the state
- Even with interoffice density, CLECs cannot match efficiencies in ILEC switch/transport network with only one switch
  - Example: CLEC must pay for interoffice transport of a call **even if** that call originates and terminates at same end office
  - Bells do not incur that cost with switches in each CO